



## Chapter 2

# CAPITAL PLANNING AND BUDGETING IN VIRGINIA

**T**his chapter presents an overview of the long-range capital outlay planning and budgeting process in the Commonwealth. It starts with a definition of capital expenditures and then describes the various funding methods the Commonwealth uses to acquire and maintain its buildings and infrastructure.

### Definition of capital outlay

The Appropriation Act authorizes the expenditure of current revenues over a two-year period. It contains two types of budgets: an operating budget and a capital budget. The operating budget shows those expenditures associated with the activities and programs provided by state agencies and institutions of higher education. The capital budget deals with large, non-recurring expenditures such as the construction of a building, repairs and improvements to a water supply system, or the installation of a new sewage system. An operating budget appropriation is limited to the costs of running operations for each year of a biennium. A capital budget appropriation is limited to the cost of the item, and may be expended over a longer period of time until the project is completed.

In addition to the cost for construction, costs associated with a capital project include:

- > Architectural and engineering services;
- > Installed equipment; and,
- > Site development and improvements.

The cost, size, and scope of a project determine whether a project is included in the operating or capital budget. For budgeting purposes, Virginia defines a capital project as a tangible asset, such as land or a building, costing more than \$250,000 to construct or \$500,000 to improve. However, there is some discretion in determining whether expenses related to property, plant, and equipment should be included in the operating or capital budget.

There are four categories of capital projects – acquisition, new construction, improvements, and equipment. The table below defines the four categories of capital projects and gives criteria for determining when the expenditure goes in the operating or capital budget. The guidelines apply whether the facility is owned or leased by the state.

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Table 1

## Categories of capital projects

**Acquisition** consists of obtaining any interest in real property, including improvements of any kind located on the acquired land, except certain utility easements. All acquisitions are subject to the capital outlay process. Leases are included in the capital budget if:

> The lease agreement involves the acquisition or improvement of real property, as that term is defined  
> in the Commonwealth Accounting Policy and Procedures (CAPP) Manual;

> The equipment obtained through the lease would meet the capital project definitions if it was  
> purchased outright; or,

> The acquisition or improvement of real property financed by a lease agreement has a project cost  
equal to or in excess of \$5.0 million. "Project cost" is equal to (1) the annual amount of the lease  
payments multiplied by the number of years of the lease, including the automatic renewal  
periods, up to a maximum of 20 years, or (2) the expected total of all annual lease payments over  
the term of the lease if the lease amount varies from year to year.

**New construction** is a single undertaking involving construction of one or more facilities. It includes: (1) construction of or site work for a new facility; (2) any addition, expansion, or extension to a structure that adds to its overall exterior dimensions; and (3) complete replacement of a facility. If a new construction project meets one or more of the following criteria, it is subject to the capital process:

> It creates additional building space of 5,000 square feet or greater;

> It has a total project cost of \$250,000 or greater; or,

> It is acquired through a lease with options to purchase or any other alternative financing approach.

**Improvements** are a complete and usable change to an existing facility or structure. Improvements include (1) alteration or conversion of interior space and other physical characteristics, (2) renovation to a facility or its infrastructure, (3) restoration of a facility or structure, and, (4) major repairs to restore a facility or system. If an improvement costs \$500,000 or greater, it is subject to the capital process.

**Equipment** is a tangible resource of a permanent or long-term nature used in an operation or activity. No precise criteria exist to help determine whether equipment is an operating or capital expense.

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The on-going operational costs of property, plant, and equipment, regardless of the expense or method of financing should be included in the operating budget. These expenses include employee compensation costs, utility bills, rental charges, supplies, and materials.

Any capital project included in an agency's operating budget because the project's cost falls below the dollar threshold for capital must normally be completed within the fiscal year in which the funds are appropriated. This time limit constraint of the operating budget and the existing dollar thresholds on projects that can be included in the operating budget ensure that only low-cost capital expenditures are funded in the operating budget.

Projects funded in the operating budget are not subject to the state's capital outlay review process. However, all construction projects funded through the operating budget must still meet the following requirements:

> The Uniform Statewide Building Code;  
> The Commonwealth's Handicapped Accessibility Standards;  
> The Department of Environmental Quality for environmental impact statements for projects costing over  
> \$100,000; and  
> The agency's approved Master Site Plan.

Furthermore, §2.1-488.4 of the Code of Virginia provides that an agency or institution of higher education may not begin construction or erection of a building or remodeling, removal, or addition to the exterior of an existing building unless the Art and Architectural Review Board has approved its design and proposed location.

## Major capital expenditures in operating budgeting

Below is a summary of some of the major expenditures of a capital nature that are included in the operating budget. The largest such expenditure is the Department of Transportation's highway construction program. The Commonwealth also provides funds through its operating budget for capital expenditures for facilities owned and operated by local governments and public organizations.

**The state highway system.** The highway construction and maintenance program is an ongoing activity that is supported by specified revenue sources. The General Assembly has established in statute the general policies regarding the distribution of these funds between maintenance and construction needs among the various state highway systems. The distribution policies include formulas for the allocation of funds among and within construction districts.

The Commonwealth Transportation Board has the responsibility for allocating funds to specific projects, within the revenue framework established by statute. For example, the Appropriation Act will appropriate funds for construction of primary highways in accordance with the statutory formula distributing funds among the interstate, primary, secondary, and urban systems. The board will allocate the primary funds according to the statutory formula. It will then allocate the funds to specific projects after consideration of recommendations made by staff and the recommendations made by the public and local officials in a series of public hearings.

**Loans and grants to local governments.** Virginia also provides funds through its operating budget for capital expenditures for facilities owned and operated by local governments, special authorities, or other public organizations. This funding goes primarily to local infrastructure projects such as road construction, airport improvements, water and sewer system construction, and port improvements. However, capital assistance is also provided for other types of facilities. Examples include sharing in the cost of local jail and juvenile facility construction, energy conservation improvements at schools and hospitals, improvements to public radio and television stations, construction of shell buildings, and historic preservation renovations.

Financial aid for local government capital expenditures is distributed through two funding mechanisms -- loans and grants. The state administers a number of loan programs. One type of loan program is the revolving fund. Examples include the Virginia Water Facilities Revolving Fund, the Virginia Historic Preservation Revolving Fund, and the Literary Fund (a constitutionally restricted fund that is primarily used to make loans for public school construction). This type of loan fund is designed to be self-sufficient by using repayments to make loans for additional projects. Some of the revolving funds continue to receive state and federal funds to increase their fund balances to a level at which they can become self-sustaining.

Other loan programs include a grant and loan program for land and water conservation projects and a "shell building" program to fund the construction of industrial buildings. These buildings, which may be easily converted to meet business prospects' needs, are also available for purchase.

The largest capital-related expenditure made out of the state's operating budget for local governments is funding for jail and juvenile facilities construction. For the last decade, the Commonwealth has paid up to 50

percent of the cost of local and regional jail construction. In addition, the 1993 General Assembly passed a new law under which the Commonwealth may reimburse localities for “financing” costs as well as “bricks and mortar” costs. The General Assembly, upon recommendation from the Department of Planning and Budget, determines the method of reimbursement. Localities may be reimbursed in one of three ways, either: (1) in one lump sum payment upon completion of the project, for minor renovation projects, or two equal lump sum payments, one at 50 percent completion of construction and the second at 100 percent completion of construction, (2) over time through a contractual agreement between the locality or authority and the Commonwealth Treasury Board, or (3) in one lump sum payment by the Virginia Public Building Authority at the completion of the project.

Localities may also receive reimbursement of up to 50 percent of the construction costs for juvenile correctional facilities. However, reimbursement for these facilities does not include any financing costs.

The balance of capital assistance to localities is distributed in the form of competitive and categorical grants. Funding is provided for airport construction and maintenance, flood control and dam safety improvements, and water and sewer projects, to name a few.

## Overview of the Capital Outlay Process

Virginia’s capital outlay process is complex. It consists of three distinct phases: budget development, legislative review, and execution. This multi-layered planning and execution process can take as little as 18 months or as long as five to eight years from the initial project proposal to completion of construction.

Table 2 below summarizes the key dates for the six-year capital outlay submissions. Following the table, there is a brief overview of the three phases.

**Table 2**

### Biennial budgeting: Key dates for the agency six-year capital budget submissions

<b><i>Date</i></b>	<b><i>Action</i></b>
<b>April</b> ( <i>odd-numbered years</i> )	Agencies notified of which high-priority projects in existing six-year plan to prepare detailed narrative justifications and schematic information.
<b>May to August</b> ( <i>odd-numbered years</i> )	Agencies conduct issue assessments and revise strategic plans.
<i>(continued on next page)</i>	
<b>May</b> ( <i>odd-numbered years</i> )	Agencies submit six-year capital requirements including maintenance reserve requests and capital leases.
<b>June</b> ( <i>odd-numbered years</i> )	Agencies submit detailed information for high-priority projects authorized in April.
<b>July</b> ( <i>odd-numbered years</i> )	Agencies (1) are notified of other projects in their May six-year plan to prepare detailed narrative justifications and schematic information, and (2) submit information on existing capital leases.
<b>August</b> ( <i>odd-numbered years</i> )	DPB validates maintenance reserve subprojects that meet criteria.
<b>September</b> ( <i>odd-numbered years</i> )	Agencies submit (1) detailed information for projects authorized in July, (2) annual maintenance reserve plan, and (3) financial feasibility studies for revenue bond projects.

<b>December</b> ( <i>odd-numbered years</i> )	Governor submits Executive Budget to the General Assembly.
<b>April</b> ( <i>even-numbered years</i> )	Biennial Budget enacted, effective July 1.
<b>Fall</b> ( <i>even-numbered years</i> )	Agencies submit capital requests for emergency projects or to supplement projects that have been bid but have insufficient funds.
<b>December</b> ( <i>even-numbered years</i> )	Governor submits Executive Budget amendments to the General Assembly.
<b>March</b> ( <i>odd-numbered years</i> )	Amendments to biennial budget enacted, effective upon passage.

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## Budget development

The first phase of the capital outlay process is budget development. During this stage, state agencies and institutions of higher education submit their capital requests to the Governor. The agencies and institutions work with two central agencies, the Department of Planning and Budget (DPB) and the Department of General Services (DGS), to define and refine the project budget and scope.

The state's biennial budget process limits capital funding requests to even-year sessions of the General Assembly. By statute, consideration of capital projects in odd-numbered years is restricted to:

- > Supplementing projects which have been bid and determined to have insufficient funding; and
- > Funding projects declared by the Governor to be of an emergency nature and/or required for the continued use of existing facilities.

In odd-numbered years, agencies identify their priority capital outlay needs for the next six years. For those projects requested for the first biennium, agencies must provide justification in terms of demand (public use), costs, and benefits. DPB and the Governor's Cabinet Secretaries review the programmatic need for these requested projects to determine which are the most critical. Agencies are then asked to prepare detailed narrative and conceptual information on the highest priority projects.

The narrative justification provides a carefully reasoned explanation of the need for the project, describes what the project entails, demonstrates how the project relates to the agency's strategic and master plans, and identifies project costs. The following depicts the type of information agencies must consider in the narrative:

- > Adequacy of existing facilities to meet current and projected program demands;
  - > Total estimated cost of the project and the methodology used to develop the estimates;
  - > What services will be initiated, expanded, or improved because of the project;
  - > Impact the proposed project will have on services and the agency's customers;
  - > Alternatives considered and the rationale for selecting the requested project;
  - > Proposed planning and construction schedule;
  - > How the project fits into the agency's approved Master Site Plan and strategic plan;
- and
- > The agency's future plans for the facility, such as any possible expansion or conversion.

The conceptual information, formally called project definition worksheets, identifies design parameters and any special requirements associated with the project. These worksheets are used to refine the scope of the project and its cost. To account for special circumstances, agencies identify any unique conditions that may affect the project.

DGS takes the lead in assessing the reasonableness of the project's cost. The department evaluates the proposed project scope and compares its cost to the cost of similar state projects contained in a database of

cost information. In addition, DGS compares the agency's request to various industry standard cost-estimating guides.

A project team reviews the most complex capital projects. These project teams have interagency participation, consisting of representatives from DPB, DGS, the requesting agency, legislative money committee staff, and, if applicable, the State Council on Higher Education for Virginia, the Department of Mines, Minerals and Energy (for energy-related projects), and the Department of Environmental Quality. The project teams provide an excellent forum to convey and discuss the project's construction characteristics, including any unique requirements. The teams are charged with determining:

- > How much space is needed;
- > Project budget; and,
- > Length of time to design and construct the facility.

During its review, the project team discusses and evaluates options to the requested projects. To evaluate the need for a project, Virginia utilizes life cycle cost techniques, space utilization guidelines, regression analyses, cost-benefit analyses, cash/revenue/expenditure forecasting, and financial feasibility assessments (bond projects).

The options identified by the project team can include deferring the project to a later biennium or accomplishing the same objective in a less costly manner, such as renovating an underutilized facility rather than constructing a new facility. As a general rule, necessary renovations to existing facilities are usually given higher priority than new or replacement facilities.

Whenever the cost of renovation or adaptive re-use approaches the cost of a new facility, the decision process may lead to the complete replacement of an old facility. If buildings are no longer needed and other programmatic requirements do not exist that could be satisfied through the adaptive re-use of the building, the state may pursue disposal of the building through sale or transfer to another public entity.

Finally, DPB and the Governor's Cabinet Secretaries prioritize the capital requests based on the Governor's policy goals and the availability of funds. This phase concludes with the Governor including the highest priority projects in the Executive Budget.

## **Legislative review**

During the next phase, the General Assembly reviews and evaluates the Governor's capital budget and adopts a general appropriation act. The General Assembly may modify or delete projects included in the Executive Budget or add new projects before passing the Appropriation Act.

## **Budget execution**

Once the General Assembly appropriates funds, the project enters its third and final phase: budget execution. Before any planning for the project or construction can begin, the Governor must grant authorization to proceed with the project. At this point, the project's budget and scope are defined.

After funding for a project has been approved and the Governor has authorized its initiation, the central budget agency uses several techniques to monitor and control the expenditure of capital funds. These oversight capabilities provide feedback that is very beneficial to capital decision-making.

First, DPB limits agency access to appropriated funds. Funds are allotted for agency expenditures as the project progresses through its various stages. After the Governor approves the project's initiation, DPB allots enough of the appropriated funds to allow planning to proceed through the working drawings stage. Working drawings are complete plans from which bids are prepared and the facility is constructed. Usually

this first allotment equals 75 percent of the amount budgeted for architectural and engineering fees.

Once the construction contract has been awarded, DPB allots up to the bid amount for construction and equipment and adds an amount for project contingencies, usually no more than five percent of the construction contract. Allotments can also be made at this time to cover the remaining architectural and engineering fees and project inspection. To access the remaining appropriated funds, the agency must submit a request that describes and justifies the need for additional dollars to be allotted. This control of allotments prevents the frivolous expenditure of public funds.

The second method of monitoring capital expenditures is through the reappropriation of project balances at the end of a fiscal year. As part of year-end close activities, agencies must provide DPB with a status update on all current capital projects. The purpose of this exercise is to identify any unobligated and unexpended balances that can revert and projects that can be closed out because they are completed. Unexpended balances are reappropriated if the project meets at least one of the following conditions:

- > Construction is in progress;
  - > Equipment purchases have been authorized by the Governor but not received;
  - > Plans and specifications have been authorized by the Governor but not completed;
- or,
- > Obligations were outstanding at the end of the fiscal year.

During budget development in the fall, DPB conducts a similar review of the status of existing projects to determine if there are any unexpended or unobligated funds that can revert.

Project monitoring is also achieved through the requirement for central government approval at various stages during project design and construction. For example, agencies must report on certain project milestones. These dates and activities are captured in the DGS central database. This database forms the basis of the department's semi-annual capital outlay progress report that is provided to leaders in the executive and legislative branches. DGS also monitors other indicators such as actual versus estimated design time, cost and number of construction change orders, and elapsed time from project approval to building occupancy.

## **The Commonwealth's capital funding program**

Government entities, including Virginia state government, generally have two options available for funding the requirements of conducting business: cash and debt. Routine operating expenses are generally paid from current revenues (cash) as expenditures occur. This financing option is often referred to as "pay-as-you-go" funding. Debt, which involves financing expenses over an extended period, is used for capital expenditures that involve long-term tangible assets, such as land and buildings. This financing option is often referred to as "pay-as-you-use," because the payment period extends over the useful life of the asset. Thus, the users of the asset are paying for it rather than just those paying taxes when it was acquired.

The Commonwealth uses both "pay-as-you-go" and "pay-as-you-use" financing techniques for capital expenses. Prior to 1990, the Commonwealth had a consistent practice of constructing and maintaining state facilities from current revenues (cash). Biennial cash appropriations for capital projects averaged about two percent of general fund revenues between 1980 and 1990. Since 1990, biennial cash appropriations for capital projects have averaged over 2.5 percent of general fund revenues.

With cash appropriations as the primary funding mechanism, the use of debt was limited to unusual circumstances and special projects. Two general obligation bond issues were passed in 1968 (\$81 million) and 1978 (\$125 million) to fund capital projects for higher education, mental health, corrections, ports, and state parks. Transportation debt was issued primarily for toll roads. The Virginia Public Building Authority was



created in 1984 and is used primarily to finance state office buildings and, occasionally, for prisons. Dormitories, dining halls, student centers, and other auxiliary projects at institutions of higher education were financed with either revenue bonds issued by the institution or with Section 9(c) Commonwealth general obligation bonds, both to be repaid by student fees.

When the Lottery began operation in 1989, Lottery revenues were originally designated for capital outlay. In 1989, \$291 million was authorized for capital projects from anticipated Lottery revenues. Another \$184 million for capital projects was authorized in 1990. When the recession of 1990 occurred, Lottery revenues were diverted from capital outlay to the operating budget to help address the \$2.2 billion revenue shortfall in the 1990-92 biennium. Lottery revenues continued to be transferred into the general fund for general purposes until FY 1999. Since then, lottery revenues have been dedicated for primary and secondary education purposes.

In the late 1980s, the downturn in the economy led to lower construction costs and a reduction in long-term interest rates. In response to these economic conditions and increased need, the Commonwealth turned to debt and other methods of paying capital expenses. On November 3, 1992, Virginia voters approved a statewide referendum for the sale of general obligation bonds to finance badly needed construction and renovation projects at institutions of higher education, state parks, and mental health and mental retardation facilities. Approximately \$613 million in general obligation bonds were approved to fund 128 projects.

In the late 1990s, additional authorizations for "pay-as-you-use" financing declined due to the availability of increased general fund revenue associated with the growing economy and an effort to limit debt to ensure that the Commonwealth maintained its "triple-A" bond ratings.

Table 3 summarizes capital outlay funding for the past three biennia, from both current revenues and debt financing. As the table illustrates, "pay-as-you-go" financing for capital projects has increased for the last three biennia. This reversal of the Commonwealth's escalating debt trend will have a positive impact of the state's current and future debt capacity.

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**Table 3**  
**Funding for capital expenditures**  
**summarized by funding option**  
\$ in millions

	<i><b>1994-1996</b></i>	<i><b>1996-1998</b></i>	<i><b>1998-2000</b></i>	<i><b>2000-2002</b></i>
Current Revenues	405.4	461.3	831.0	730.7
Debt Financing	599.6	500.3	329.2	233.3
<b>Total</b>	<b>\$1,005.6</b>	<b>\$961.6</b>	<b>\$1,160.2</b>	<b>\$964.1</b>

1. Figures may not add due to rounding.

2. Current revenues consist of general fund dollars, special funds, higher education operating funds, Commonwealth transportation funds, trust & agency funds, dedicated special funds, federal trust funds, internal services fund, and enterprise funds.

3. Debt Financing represents tax-supported debt authorized during the biennium.

Source: Department of Planning and Budget and the Department of the Treasury

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## "Pay-as-you-go" funding

There are several reasons to finance capital projects using cash. First, costs are not imposed on future residents. Second, the cost of capital expenditures is reduced because there are no interest costs and expenses for issuing debt. However, relying exclusively on cash can be restricting. As recent history proved, cash may be insufficient at times to address all major capital needs.

During the past six years, there has been an increase in projects funded with general fund revenues. The biggest jump in projects funded with general fund dollars occurred in the 1994-96 biennium. This was the biennium following the issuance of the 1992 general obligation bond. Table 4 on the following page shows the funding pattern over the last two biennia and identifies what has been included in the 2000 Appropriation Act.

In recent years, general fund appropriations have been used primarily for the following types of capital outlay projects:

- > Infrastructure repair projects aimed at maintaining or extending the useful life of an existing facility;
- > Projects to address hazardous situations representing immediate threats to life and health; and
- > Projects to replace or renovate substandard and inefficient facilities.

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**Table 4**  
**“Pay-as-you-go” appropriations for capital projects:**  
**summary by fund source**

\$ in millions

	<b>1996-1998</b>		<b>1998-2000</b>			<b>2000-2002</b>		
	<i>Dollars</i>	<i>% of Total</i>	<i>Dollars</i>	<i>% of Total</i>	<i>% Change</i>	<i>Dollars</i>	<i>% of Total</i>	<i>% Change</i>
General Fund	122.4	26.53%	403.8	36.85%	229.90%	306.0	41.88%	-24.22%
Nongeneral Fund	338.8	73.44%	691.9	63.15%	104.22%	424.7	58.12%	-38.62%
<b>Total</b>	<b>\$461.3</b>	<b>100.0%</b>	<b>1,095.7</b>	<b>100.0%</b>	<b>137.52%</b>	<b>730.7</b>	<b>100.0%</b>	<b>-33.31%</b>

Figures may not add due to rounding. "Percent change" columns do not add because they represent change over previous biennium.  
Source: Department of Planning and Budget

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Table 5 on the following page breaks out the general fund capital outlay budget for the last two biennia by project type and identifies what has been included in the 2000 Appropriation Act. The project categories are:

- **Infrastructure repair projects.** Infrastructure repair projects are aimed at maintaining or extending the useful life of an existing facility. They consist of major repairs to restore a facility, mechanical system, or utility system to a condition that allows it to be appropriately used, including the reprocessing or replacement of parts or materials that have deteriorated by action of the elements or through "wear and tear" from usage. Repair projects also include projects to correct deficiencies such as roof repairs and replacements; electrical repairs; replacement of heating, ventilation, and air conditioning systems; and parking lot repairs.

This category (infrastructure repair projects) also includes "maintenance reserve" appropriations. Maintenance reserve projects consist of low-cost repairs or replacement of plant, property, or equipment. Generally, each maintenance reserve subproject costs between \$25,000 and \$500,000.

- **Life safety and handicapped access projects.** Life safety projects correct situations representing immediate threats to life and health. For example, these include compliance with U.S. Environmental

Protection Agency regulations related to the repair and upgrade of underground storage tanks, asbestos and lead-base paint abatement, and the state match for remediation of hazardous waste sites under the federal Superfund program. Other legally mandated projects include fire safety code renovations and renovations to make facilities accessible to handicapped individuals.

- **Improvements.** An improvement is defined as all work necessary to produce a complete and usable change to an existing facility or structure, including the associated architectural and other technical services, the fixed equipment installed and made part of the facility or structure, and site development. Improvements include the alteration or conversion of the interior space arrangement, renovation of most or all of a facility or facility component, and restoration of a facility or structure to the maximum extent possible to its former or original state (historic property).
- **New construction and acquisition projects.** Acquisition consists of obtaining any interest in land, including improvements of any kind located on the acquired land, except certain utility easements. A new construction project is a single undertaking involving construction of one or more facilities. Included in the project are: all work necessary to accomplish a specific purpose and produce a complete and usable new structure, the associated architectural and other technical services, the equipment installed and made part of the facility, and site development and improvements.
- **Equipment.** Equipment is defined as a tangible resource of a permanent or long-term nature used in an operation or activity. During the 1998-2000 biennium, the total amount approved for equipment purchases was -\$16.3 million. This amount represented an equipment reversion, which the General Assembly approved because the construction of several educational facilities had not been completed. However, the 2000 Appropriation Act restores equipment funding for these facilities, which were recently completed. In addition, the 2000 Appropriation Act also provides funding for additional equipment purchases at Virginia's universities and community colleges.
- **Planning.** Planning projects provide the resources necessary to complete the design work for facilities that may possibly be constructed by the Commonwealth in the future. The provision of planning dollars, however, does not obligate the Commonwealth to construct these facilities.

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**Table 5**  
**General fund capital budget**  
**summarized by category of project**

\$ in millions			
<i>Type of Project</i>	<i>1996-1998</i>	<i>1998-2000</i>	<i>2000-2002</i>
Infrastructure repair project	81.0	121.5	141.0
Life safety & access projects	15.2	20.0	21.3
Improvements	11.9	129.6	68.2
New construction & acquisition	14.4	140.0	51.3
Equipment	0.0	-16.3	12.7
Planning	0.0	9.1	11.6
<b>Total</b>	<b>\$122.4</b>	<b>\$403.9</b>	<b>\$306.1</b>

Figures may not add due to rounding. Source: Department of Planning and Budget

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## "Pay-as-you-use" funding

Every state and almost every municipality uses debt financing to some degree. In the early 1990s, as

Virginia struggled through a recession, economic conditions and lower interest rates reduced the cost of construction. To take advantage of these lower interest rates and reduced construction costs and to preserve resources for other priorities, Virginia turned to debt financing and other methods for paying the cost of capital projects. The principal method of debt financing is long-term bonds. However, short-term debt is used as well for assets with shorter useful lives or for funding in anticipation of issuing long-term bonds.

State debt falls into two broad categories, defined by the source or method of repayment: tax-supported debt and non-tax-supported debt. Tax-supported debt is that debt for which the debt service is paid or ultimately pledged to be paid from general governmental funds. Non-tax-supported debt constitutes everything else. The most common type of tax-supported debt is general obligation debt. General obligation debt is that debt which carries the "full faith and credit" and taxing power of the issuer to repay the debt. Article X, Section 9 of the Virginia Constitution, provides for the issuance of debt by or on behalf of the Commonwealth. Sections 9(a), (b) and (c) provide for the issuance of general obligation debt and Section 9(d) provides for the issuance of debt not secured by the full faith and credit of the Commonwealth, but which may be deemed tax-supported debt of the Commonwealth.

### **Tax-supported debt -- general obligation debt**

Article X, Section 9 of the Virginia Constitution authorizes three categories of general obligation debt:

**Section 9(a) debt.** Debt incurred under Article X, Section 9(a) may be issued to meet emergencies, to redeem previous debt, or, on a short-term basis, to meet casual deficits in revenue or in anticipation of collection of revenues.

**Section 9(b) debt.** Debt incurred under Section 9(b) is long-term debt for capital projects. It must be authorized by a majority vote of each house of the General Assembly and approved in a referendum by the citizens of the Commonwealth. The source of funds for repaying this debt is general fund revenues of the Commonwealth.

**Section 9(c) debt.** Debt incurred under Section 9(c) is long-term debt for revenue-producing capital projects. This debt is issued as "double barreled" bonds, which are backed by both the revenues of the projects and the full faith and credit of the Commonwealth. Issuance of Section 9(c) debt requires a two-thirds vote of each house of the General Assembly and certification by the Governor that net revenues will be sufficient to meet principal and interest payments on the debt. Should project revenues prove insufficient, the state's full faith and credit is pledged to repay the debt.

Of the three types of general obligation debt, that issued under the authority of Section 9(c) is used most often. Debt issued under the authority of Section 9(b), on the other hand, has been used sparingly. Only two general obligation bond referenda have been held since the Constitution was reconstituted in 1971 -- in 1978 and 1992. Debt issued under the authority of Section 9(a) for civil emergencies, short-term cash flow needs, and refundings is rarely used except for refundings of outstanding general obligation bonds.

Bonds issued under Section 9(c) are used to fund revenue-producing projects. The project revenues pay the debt service on the bonds. Section 9(c) bonds are issued for three areas of government -- higher education, transportation, and general government. Projects funded with Section 9(c) bonds include dormitories, dining halls, parking projects, toll roads, and bridges. Section 9(c) bonds are also used by the Department of Transportation to fund toll roads, and by the Department of General Services to fund parking facilities.

On November 3, 1992, Virginia voters approved a statewide referendum for the sale of general obligation bonds issued under the authority of Section 9(b). Approximately \$613 million was approved to fund projects for higher education, parks and recreation, and mental health. Of the \$613 million, \$472.4 million was approved to fund the construction and renovation of educational and general space at institutions of higher education and museums; \$95.4 million to fund park acquisition and construction; and \$45.2 million to fund renovations and improvements to mental health and mental retardation facilities. The final bonds were issued under this authorization in October 1999.

## Other tax-supported and non-tax-supported 9(d) debt

Section 9(d) of Article X provides that the restrictions of Section 9 are not applicable to any obligation incurred by the Commonwealth or any of its institutions, agencies, or authorities if the full faith and credit of the Commonwealth is not pledged or committed to the payment of such obligation. There are various types of 9(d) revenue bonds (nongeneral obligations) issued by authorities, institutions, and agencies for which the Commonwealth's full faith and credit is not pledged. Certain of these bonds, however, are paid in whole or in part from revenues received as appropriations by the General Assembly from general and nongeneral fund revenues, while others are paid solely from revenues derived from self-supporting enterprise systems, or payments from local governments. The former are considered tax-supported debt while the latter are not. General law authorizes the issuance of this debt.

"Pay-as-you-use" financing or debt financing issued pursuant to Article X, Section 9(d) of the Constitution is used to finance a variety of state and local capital outlay projects. Whether the obligations are considered tax-supported or non-tax-supported debt of the Commonwealth is largely a function of the revenue stream used to repay the obligations. If the proceeds of the obligations were used to finance a local project and such obligations were repaid with local funds, then such obligations would not be considered tax-supported debt of the Commonwealth. The state programs and local programs are described in detail below.

Table 6 summarizes "pay-as-you-use" financing over the last three fiscal years.

<b>Table 6</b>			
<b>Outstanding Commonwealth debt</b>			
	\$ in millions		
	<i>For the Fiscal Year Ended June 30,</i>		
<b>Tax-Supported Debt:</b>	<b>1997</b>	<b>1998</b>	<b>1999</b>
<b>General Obligation Debt</b>			
Section 9(a) Debt	\$0	\$0	\$0
Section 9(b) Debt (Voter approved)	539.1	568.5	554.8
Section 9(c) Debt (Revenue backed)	<u>601.8</u>	<u>571.4</u>	<u>554.2</u>
Subtotal General Obligation Debt	1,140.9	1,139.9	1,108.9
<b>Other tax-supported debt</b>			
Section 9(d) Bonds			
Virginia Public Building Authority	902.6	942.7	965.9
Transportation Debt	733.2	756.7	737.0
Virginia College Building Authority	146.0	217.6	248.2
Virginia Port Authority	114.0	108.1	106.8
Innovative Technology Authority	13.1	12.6	12.2
Other Long-Term Debt	<u>765.0</u>	<u>946.1</u>	<u>1,043.0</u>
<b>Total Tax-Supported Debt:</b>	<b>3,814.8</b>	<b>4,123.7</b>	<b>4,222.0</b>
<b>Non-Tax-Supported Debt:</b>			
<b>Section 9(d) Moral Obligation Bonds</b>			
Virginia Housing Development Authority	1,179.8	1,333.4	1,503.9

Virginia Public School Authority	739.1	542.4	514.5
Virginia Resources Authority	337.8	362.8	326.6
Section 9(d) Other Debt	334.8	325.7	390.7

*Continued on next page*

**Table 6**  
**Outstanding Commonwealth debt**

	\$ in millions		
	<i>For the Fiscal Year Ended June 30,</i>		
	<b>1997</b>	<b>1998</b>	<b>1999</b>
<b>Other Long-Term Debt</b>			
Virginia Housing Development Authority	3,514.7	3,953.1	4,364.4
Virginia Public School Authority	812.1	1,113.2	1,269.8
Pocahontas Parkway Association Bonds	0	0	381.7
Other Long-Term Debt	<u>358.4</u>	<u>406.8</u>	<u>523.2</u>
<b>Total Non-Tax-Supported Debt:</b>	<u>7,276.7</u>	<u>8,037.4</u>	<u>9,274.9</u>
<b>Total Debt of the Commonwealth:</b>	<u>\$11,091.6</u>	<u>\$12,161.1</u>	<u>\$13,496.9</u>

\* Figures may not add due to rounding. Source: Department of the Treasury / Department of Accounts

## Section 9(d) debt -- state programs

Section 9(d) debt is issued to fund capital outlay projects of state agencies by a number of different entities or authorities.

- > **Higher Education Section 9(d) Debt.** Institutions of higher education issue Section 9(d) debt based on their own credit through a pledge of their general revenues, or as pure revenue bonds with specific revenue sources pledged, such as the revenues of a teaching hospital. This financing mechanism is realistically open only to those institutions with strong financial underpinnings. This debt is issued by the institution and sold directly to investors without using a separate conduit entity.
- > **Virginia Department of Transportation Section 9(d) Debt.** The Commonwealth Transportation Board (CTB) issues all Section 9(d) bonds for highway construction projects. Projects currently funded with Section 9(d) bonds include the U.S. Route 58 Corridor Development Program, five projects for the Northern Virginia Transportation District, Oak Grove Connector in the City of Chesapeake, Route 28, and the Route 234 Bypass. The security structure for these bonds differs with the particular revenues appropriated from specific funds established for the projects to collect certain revenues such as state recordation taxes attributable to the jurisdiction(s) in which the project is located, and the Transportation Trust Fund (TTF). The General Assembly may also provide additional appropriations. All CTB debt is considered tax-supported debt. (*See Section 9(d) – Local Programs*)
- > **Virginia Public Building Authority.** The Virginia Public Building Authority (VPBA) issues bonds to finance the construction of state facilities, such as prisons, as well as the state's reimbursement to localities and regional jail authorities for the state's share of approved construction costs of local and regional jail facilities. The VPBA has been one of the Commonwealth's most consistent issuers of debt over the last several years. Prior to 1997 the VPBA issued "lease revenue bonds" under which the VPBA held title to (owned) the projects financed and leased the facilities to the managing agencies. In 1997 the VPBA created a new indenture under which title remains with the managing agencies (Commonwealth) and payments are made to the VPBA under a payment agreement. Payments due under the payment agreements, like the lease payments under prior issues, are subject to appropriation by the General Assembly and are used by the VPBA to pay the debt service on its bonds. All VPBA debt is considered tax-supported debt.

development purposes. The Innovative Technology Authority (ITA) financed a portion of the Center for Innovative Technology (CIT) through the issuance of Section 9(d) bonds. The security structure for the ITA bonds involves an underlying lease agreement where lease payments are appropriated by the General Assembly in amounts sufficient to pay debt service on the bonds. These bonds are considered tax-supported debt.

- > **Virginia College Building Authority.** The Virginia College Building Authority (VCBA) issues bonds to finance projects for public higher education institutions through its pooled bond program, its 21st Century program, and its equipment financing program. It acts as a conduit issuer for private higher education institutions to issue tax-exempt bonds for certain “qualifying” facilities. The VCBA pooled financing program provides a method by which higher education institutions can finance projects by issuing obligations through the VCBA. The VCBA issues its bonds and buys notes issued by the institutions. Payments made by the institutions on their notes are used by the VCBA to repay its bonds. This saves the institutions in interest costs and administrative time. The VCBA pooled program bonds are not considered tax-supported debt.

The VCBA 21st Century program and the equipment financing program provide institutions with funding for capital projects and equipment needs. Debt service, primarily funded from general fund dollars, on these obligations is appropriated by the General Assembly and is considered tax-supported debt. Prior to 1999, the equipment bonds issued through the Higher Education Equipment Trust Fund (HEETF), were secured by lease agreements with the institutions. However, the bonds issued under the current program are not secured by lease agreement with the institutions.

- > **Virginia Biotechnology Research Park Authority.** The Virginia Biotechnology Research Park Authority represents another example of debt issued under Section 9(d) for economic development purposes. Bonds issued by this authority are used to finance facilities for the Virginia Biotechnology Research Park in Richmond, Virginia. One series of bonds issued in 1996 which financed facilities for the Division of Forensic Science and the Office of the Chief Medical Examiner, are structured similar to the ITA bonds with an underlying lease agreement with the Department of General Services where lease payments are appropriated by the General Assembly in amounts sufficient to pay debt service on the bonds. These bonds are considered tax-supported debt.
- > **Virginia Port Authority.** The Virginia Port Authority (VPA) issues Section 9(d) bonds to finance the construction of port facilities in Virginia, primarily in the Hampton Roads area. The security structures for these bonds differ, with some bonds secured only by the particular revenues appropriated from specific funds established for the projects financed, and others secured by the Commonwealth Port Fund. The General Assembly may also provide additional appropriations. Some debt is not considered tax-supported debt if secured solely by revenues from a particular project.
- > **Other Section 9(d) Debt – State Programs.** Other state-level authorities have issued bonds on a limited basis to support agricultural and economic development activities. Authorities have also recently been created by the General Assembly to finance the construction of a baseball stadium for a Major League Baseball franchise and an arena complex for a National Hockey League or National Basketball Association franchises if awarded to Virginia.

## **Section 9(d) debt -- local programs**

Section 9(d) debt is also issued to fund capital outlay projects for local infrastructure projects. Like Section 9(d) debt issued for state projects, Section 9(d) debt for local projects is issued by a number of different entities or authorities. This debt provides indirect support to local infrastructure projects. Direct support is provided through programs where funds are made available to localities through direct subsidies or grants. Direct support mechanisms include certain Virginia Public School Authority (VPSA) programs and the regional jail reimbursement program through the Commonwealth Treasury Board or the Virginia Public Building Authority. In any event, the state issues debt in most cases to finance the grants.

Indirect support is provided through mechanisms which give easy and low-cost access to the capital

markets for localities which might not otherwise be in a position to do so, or could do so only at a relatively high cost. Indirect support mechanisms include the Virginia Resources Authority (VRA), the Route 28 and Northern Virginia Transportation District (NVTB) road construction programs, Literary Fund loans, and the VPSA pooled bond and stand-alone programs. The VPSA also provides an interest rate subsidy program which combines the features of a Literary Fund loan and a VPSA pooled bond issue, making this financing program a combination of both direct and indirect support. In addition, the VPSA provides an equipment financing program. Each of these is discussed in more detail below.

- > **Commonwealth Transportation Board.** The Commonwealth Transportation Board (CTB) issues bonds for local transportation improvement projects. These bonds constitute indirect support. The security structure for these bonds differs with the particular financing program. Contract revenue bonds issued for Route 28 financing are secured and paid primarily from real estate taxes levied in a special assessment district in the area surrounding the road. These bonds are also secured by the Commonwealth's Transportation Trust Fund (TTF). The General Assembly may also appropriate funds for these bonds, if necessary.

The CTB also issues Transportation Revenue Bonds secured by state recordation taxes, the TTF, General Assembly appropriations, and certain other monies in the case of the Northern Virginia Transportation District (NVTB) program and the Oak Grove Connector project in the City of Chesapeake. The NVTB bonds are secured by a pledge of the recordation tax revenues of the specific localities benefiting from the construction program, as well as the other provisions mentioned above, including the additional pledge of local highway allocations. The Oak Grove Connector bonds utilize the Transportation Improvement Program Set-Aside Fund in which certain distributions of state recordation taxes attributable to the participating localities are deposited and used to pay debt service on the bonds.

The 1993 General Assembly enacted legislation creating the Transportation Improvement Program Set-Aside Fund as a special non-reverting fund of the TTF. Cities and counties may elect to direct their share of annual collections of state recordation taxes to the Set-Aside Fund for transportation purposes. The fund may be used to finance transportation projects directly or to secure the debt service of transportation program revenue bonds issued by the CTB.

- > **Virginia Resources Authority.** The Virginia Resources Authority (VRA) issues bonds secured by bonds of the localities that are purchased by the VRA and by the moral obligation pledge of the Commonwealth to fund water, wastewater, and solid waste projects for localities. Moral obligation bonds are backed by a legislative commitment to consider (but not require) appropriation of general fund revenues if there are insufficient funds to meet debt service payments. These bonds are structured with a debt service reserve fund that is funded when the bonds are issued. If revenues were insufficient to pay debt service, the issuer would use funds in the debt service reserve to make-up the deficiency for the debt service payment. The issuer would then request that the General Assembly appropriate funds to replenish the reserve fund. For this reason, a moral obligation pledge is a credit enhancement; while there is not an explicit pledge, the possibility that the state may appropriate money in the unlikely event of default enhances or strengthens the issuer's credit. The moral obligation pledge allows the VRA to issue bonds with credit ratings only one step below the Commonwealth's "triple-A" general obligation bond ratings. This lowers the overall borrowing costs of the localities obtaining financing through the VRA.

In addition to the moral obligation bonds issued for local water, wastewater, and solid waste projects, the VRA instituted a new program in 1999 to leverage the Virginia Water Facilities Revolving Fund to assist localities in financing qualified wastewater projects at subsidized interest rates that does not utilize the Commonwealth's moral obligation pledge. Legislation was adopted by the 1999 General Assembly that created a new airport revolving fund program to be administered by the VRA. The airport revolving fund was not capitalized and the VRA is developing criteria for the program. The airport revolving fund bond program could utilize the Commonwealth's moral obligation pledge.

- > **Virginia Public School Authority.** The VPSA uses a number of different methods of issuing bonds to provide funds for primary and secondary public school capital projects. The VPSA primarily acts as a bond bank, whereby it uses the proceeds of its bonds to buy bonds issued by localities. Payments



received on the local school bonds are used to repay the VPSA bonds. The VPSA's main tool has been its pooled bond financing program that is considered indirect support. The VPSA has issued pooled bonds under different bond resolutions. Under its 1987 Resolution, it uses pledged Literary Fund loans to provide additional debt service coverage. The VPSA has never needed to call on the revenue from the pledged loans. The additional debt service coverage provided by the pledged loans assists the VPSA in obtaining "double-A" ratings, thereby lowering the associated borrowing costs to some localities, thus allowing them access to the capital markets which they would not otherwise be able to access on their own. Due to decreasing coverage, bonds have not been issued under the 1987 Resolution since 1993.

Under its 1991 Resolution, the VPSA also uses the moral obligation pledge of the Commonwealth that is similar to the VRA's. As in the case of the VRA, the moral obligation pledge assists the VPSA in obtaining "double-A" ratings on these bonds ("double-A plus" from Moody's), with the benefit of this high rating being passed on to localities in the form of lower interest rates than they may otherwise obtain. The VPSA has also issued insured bonds under its 1990 Insured Resolution. A bond issuer can purchase insurance for its bond issues. The insurance guarantees payment of principal and interest to bondholders in the event the issuer cannot make payments. Because payment of principal and interest is guaranteed, insured bonds are rated "triple-A." The decision to use bond insurance is based on the benefit to be obtained from the lower interest rate versus the increased cost of purchasing the insurance.

Since 1997, the VPSA issues bonds for its pooled programs under its 1997 Resolution. In lieu of Literary Fund loans or the moral obligation pledge, the VPSA 1997 Resolution has a sum sufficient appropriation from the Literary Fund and then the Commonwealth's general fund to pay debt service in the event revenues are not sufficient. The authority receives "double-A plus" ratings on these bonds.

A unique VPSA program is its interest rate subsidy program, which allows it to provide what are in essence low-rate Literary Fund loans to localities through a combination of bonds and cash subsidies from the Literary Fund. The VPSA issues bonds using one of the structures described above. Cash from the Literary Fund is used to "buy down" the interest cost of the bonds issued on behalf of localities to a level equivalent to what the locality would pay for a standard Literary Fund loan.

The VPSA also provides financing assistance through its stand-alone bond program. Under this program, the VPSA acts merely as a conduit for one local borrower at a time. The bonds are sold without any additional credit enhancement and are rated based on the credit of the underlying locality as opposed to a pooled resolution structure. The Authority utilizes this program when it cannot meet all of a particular borrower's needs through its pooled program.

The VPSA also provides direct support through the issuance of its educational technology equipment financing notes. These notes are authorized by the General Assembly and are repaid through appropriations from the Literary Fund. Proceeds of the notes are distributed to local school divisions in the form of grants as opposed to loans that must be repaid. Localities, however, must use the proceeds within parameters set forth in the Appropriation Act to purchase educational technology equipment and related infrastructure.

- > **Virginia Housing Development Authority.** The VHDA issues a number of different types of mortgage revenue bonds to finance single-family and multi-family housing for primarily low-income families. VHDA is the largest issuer of debt in the Commonwealth. Prior to FY 2000, the VHDA multi-family housing financing program utilized the moral obligation pledge of the Commonwealth. As with the VRA and the VPSA, the moral obligation pledge along with the VHDA's sizable general fund, allowed the VHDA to obtain lower interest costs on its bonds than would otherwise be possible. The VHDA now issues its multi-family housing bonds without the moral obligation pledge of the Commonwealth. The VHDA is the highest rated "double-A plus" housing finance agency in the nation.

## **Lease financing for state projects**

The Commonwealth is involved in numerous agreements to lease buildings, personal property, and other equipment. Although lease financing is not considered debt in a legal or constitutional sense, rating agencies

treat it as tax-supported debt in their credit analysis. Lease purchasing falls into two broad categories: installment purchases and capital leases. Installment purchase agreements provide for transfer of ownership of the financed property to the lessee at the beginning of the lease term and normally denotes a short-term lease arrangement to finance personal property or equipment. In most cases the agreements are collateralized by the personal property and equipment acquired. The agreements also contain nonappropriation clauses indicating that continuation of the installment purchase is subject to funding by the General Assembly. Capital lease agreements, on the other hand, may or may not provide for transfer of ownership. If ownership is transferred on a capital lease, it is done at the end of the lease term.

The Commonwealth Treasury Board is required to review and approve the terms of any contracts for the purchase of personal property whether by installment purchase, lease purchase, or any other method where payment of the purchase price is deferred through installment payments. In response to this requirement, the board established its Master Equipment Lease Program (MELP) in order to assist state agencies in financing personal property and equipment purchases. This program is an umbrella equipment financing arrangement open to all state institutions and agencies. The MELP has been used to finance the acquisition of over \$181 million in personal property and equipment since 1988. The terms and conditions of vendor-sponsored installment purchases can be compared with financing through MELP to determine the most advantageous rate and terms for the agency. The MELP has become increasingly popular because it allows users to switch from a "pay-as-you-go" approach to equipment acquisitions to a "pay-as-you-use" approach corresponding to the useful life of the equipment.

The Commonwealth Treasury Board is also required to review and approve the terms and structure of any bond issue or other financing arrangement, including those secured by leases, lease purchase agreements, financing lease, capital leases, and other similar arrangement. In addition, for any capital lease for a project whose cost exceeds \$5.0 million, the Treasury Board is required to approve the terms and structure of such lease. The board also is required to approve terms and structure of bonds or financing arrangements (including leases, etc.) where the debt service is paid, directly or indirectly, from appropriations. In addition to Treasury Board approval, computer equipment purchases must comply with all the guidelines issued by the Department of Information Technology, and real property leases must comply with guidelines issued by the Department of General Services and approved by its Bureau of Real Property Management. Therefore, one or more agencies are involved in approving capital lease arrangements for state agencies and institutions.

In certain cases, there are questions as to whether a lease arrangement will be considered an operating lease or a capital lease for purposes of accounting for the lease on the books of the Commonwealth. Policy guidance issued by the State Comptroller distinguishes between operating and capital lease agreements based on four criteria in accordance with generally accepted accounting principals. A lease is deemed to be a capital lease if it meets any one of the following four criteria:

- > Transfer of ownership of the property to the lessee at the end of the lease term;
- > Bargain purchase option at the end of the lease term;
- > Lease term is equal to 75 percent or more of the estimated economic life of the leased property; and
- > The present value of the net minimum lease payments equal or exceed 90 percent of the fair market value of the leased property.

Although long-term capital lease financing is not used widely within the Commonwealth, in recent years because of certain privatization initiatives, the Commonwealth has entered into long-term capital leases to finance two state prisons and certain other facilities.

## **Other support of local projects**

The Commonwealth currently has two programs that provide support for local projects through "pay-as-you-use" financing. These programs provide funding for primary and secondary school construction and for jail construction. However, the debt is incurred by the localities in the first case and by the state in the latter case.

- > **Literary Fund.** The Literary Fund was established in the Constitution (Article VIII, Section 8) in 1810 as a permanent and perpetual school fund for the Commonwealth. The Literary Fund derives its revenues primarily from the collection of unclaimed property, escheats, criminal fines, fees and forfeitures, unclaimed lottery prizes, investment earnings, and the repayment of Literary Fund loans.

Virginia law charges the Board of Education with the administration of the Literary Fund. The Department of the Treasury is the custodian with whom the board deposits all revenues. The Department of the Treasury provides daily management and investment services for the board as well as producing the annual forecast of revenues.

The Constitution provides that ". . .so long as the principal of the Fund totals as much as eighty million dollars, the General Assembly may set aside all or any part of additional moneys received into its principal for public school purposes, including the teachers retirement fund." As of June 30, 1999, the total principal of the Literary Fund exceeded \$417 million.

Historically, Literary Fund proceeds have been used primarily to provide low-interest loans to school divisions for public school construction. Public school construction includes erecting, altering, or enlarging school buildings. As these loans are repaid, the principal and interest payments become new revenue to the Literary Fund. This process produces a recycling effect that has kept the Literary Fund a viable source of low-interest funding for public school construction.

In recent years, Literary Fund revenues have also been used to provide for the VPSA equipment note grant program and to conduct the interest rate subsidy program, which provides school divisions with bond financing equal to the cost of a Literary Fund loan. This technique uses Literary Fund revenues to "buy down" the interest rate paid by a school division. The resulting interest rate is equal to the interest rate that a school division would pay for a Literary Fund loan.

Literary Fund revenues may also be used for payment of teacher retirement costs. When Literary Funds are not used, the state's share of teacher retirement payments must be made from the general fund. From the early 1990s until the latest biennium, Literary Funds had become the primary source of funding for teacher retirement. As a result, fewer public school construction projects were funded from the Literary Fund.

- > **Local jail construction.** The Commonwealth provides up to one-half of the cost of constructing regional jails and one-quarter of the cost of constructing local jails. Increases in the number and size of jails being built has made it costly for the Commonwealth to use "pay-as-you-go" appropriations for its share of all existing and proposed regional jail projects. In 1993, the General Assembly passed a new law under which the Commonwealth may reimburse localities for "financing" costs as well as "bricks and mortar" costs. The General Assembly, upon recommendation from the Department of Planning and Budget, determines the method of reimbursement. Localities may be reimbursed in one of three ways, either: (1) in one lump sum payment upon completion of the project, for minor renovation projects, or two equal lump sum payments, one at 50 percent completion of construction and the second at 100 percent completion of construction; (2) over time through a contractual agreement between the localities or authority and the Treasury Board; or (3) in one lump sum payment by the Virginia Public Building Authority upon completion of the project. In the most recent biennium, most of the large jail reimbursements were done on a "pay-as-you-use" basis through Treasury Board reimbursement agreements or through the VPBA. In this way, the Commonwealth can honor its commitment to jail construction without sustaining a major immediate draw on budget dollars.

## Debt Capacity Advisory Committee

In September 1991, the Debt Capacity Advisory Committee (DCAC) was created by the Governor through an Executive Order. During the 1994 General Assembly Session, the DCAC was established into law under Chapter 43 of the 1994 Virginia Acts of Assembly. The committee's membership consists of the

Secretary of Finance, the State Treasurer, the director of the Department of Planning and Budget, the director of the Joint Legislative Audit and Review Commission, the Auditor of Public Accounts, and two citizen members appointed by the Governor.

The DCAC is charged with annually estimating the amount of tax-supported debt that may prudently be authorized, consistent with the financial goals, capital needs, and policies of the Commonwealth. This estimate is provided to the Governor and the General Assembly. The DCAC also annually reviews the amount and condition of bonds, notes, and other security obligations of the Commonwealth's agencies, institutions, boards and authorities which are either secured by a moral obligation pledge to replenish reserve fund deficiencies or for which the Commonwealth has a contingent or limited liability. The DCAC must provide its recommendations on the prudent use of such obligations to the Governor and the General Assembly. In addition, the DCAC is also required to review the amount and condition of Commonwealth obligations that are not general obligations or moral obligations, and when appropriate, to recommend limits on such additional obligations to the Governor and the General Assembly. The DCAC released its first report in January 1992 and its most recent report in December 1999.

The DCAC provides a mechanism by which Virginia periodically assesses its tax-supported debt capacity. The DCAC makes recommendations each year to the Governor and General Assembly, based on two principal guidelines it has adopted:

- > The Commonwealth should maintain its "triple-A" general obligation bond ratings; and
- > The Commonwealth should not pay more than five percent of annual revenues for annual tax-supported debt service.

The model adopted by the DCAC provides a measure of debt affordability. It assumes that tax-supported debt service payments should not consume more than five percent of the "combined revenues" of the Commonwealth in any year. Tax-supported debt is defined as any debt that is paid from the general "combined revenues" of the Commonwealth. "Combined revenues" include general fund revenues, state revenues in the Transportation Trust Fund, transfers of ABC and Lottery profits, and revenues from capital projects equal to debt service on outstanding 9(c) general obligation debt. The DCAC has reaffirmed its recommendation of five percent as the maximum ratio of debt service to revenues each year since 1991.

Rating agencies view control of tax-supported debt as one of four key factors affecting credit quality. Other factors include economic vitality and diversity, fiscal performance and flexibility, and the administrative capabilities of government. Virginia's goal is to maintain its "triple-A" ratings for general obligation debt while still meeting the capital financing needs of the Commonwealth.

## **Commonwealth's credit today**

The Commonwealth's long-term general obligation debt is currently rated "triple-A" by each of the three major rating agencies. Virginia is one of only nine states to have such a distinction. The Commonwealth also carries the highest short-term rating from all three rating agencies, making it one of only two states with the highest short- and long-term ratings from all three rating agencies. Maintaining the "triple-A" ratings ensures that Virginia issues debt at the lowest possible cost of borrowing.

A number of new programs and enhancements to existing programs have been implemented in recent years to reduce the Commonwealth's cost of borrowing, ease administrative burdens and time-consuming practices, consolidate and expand bond financing programs, and eliminate unfunded mandates on local governments in refinancing their local debt.

Recently, the use of "pay-as-you-use" financing has declined due to a growing economy which has enabled more general fund dollars to be allocated for capital outlay projects. This change in funding has also occurred in an effort to limit debt to preserve debt capacity and to ensure that the Commonwealth maintains its "triple-A" bond ratings. During the last four years, total tax-supported debt authorization has declined

from the total levels recorded in the late 1980s and early 1990s.